Issuance of rate reduction bonds by utilities may be down, but the market is preparing for a surge in new asset-backed securities derived from the stranded cost model. By *Catherine Lacoursiere*

A new breed of bond

★ After a boom in securitised stranded assets over the last seven years, issuance has been down. Also known as rate reduction bonds (RRBs), Barclays Bank says $30 billion of these off-balance sheet securities have been issued since 1997, $18.8 billion of which remain outstanding. The securities were conceived to help utilities recover the stranded costs of older plants rendered uneconomical by more efficient plants but who are no longer able to recover those costs through rate-based mechanisms as a result of deregulation. Yet the majority of utilities wishing to securitise stranded costs in deregulated states have done so already – between 1997 and 2004. 2003 issuance registered under $1 billion for the first time and reached just $800 million in 2004.

Still, the market is readying for a steady stream of new issues over the next few years. Newly deregulating states will provide some liquidity, as will the identification of additional stranded assets in deregulated states. Houston, Texas-based utility CenterPoint Energy, for example, filed in December for approval for $2.3 billion in securitised bonds to fund the balance of its stranded costs. With low interest rates, CenterPoint estimates several hundred million dollars in cost savings over the traditional utility rate-based recovery mechanism. Deregulation-driven deals could translate into $6 to $8 billion in new RRB issuance over the next year, estimates Barclays Bank.

Yet the real activity is likely to come from new instruments based on the stranded asset securitisation model. These include a form of environmental trusts, economic recovery bonds and, potentially, hurricane cost recovery bonds. Like the RRB model used to recover stranded costs, the bonds will be backed by utility revenue streams by way of fees added to ratepayer's bills. But these securities are now being adopted to the recovery of a number of costs. California utilities plan on issuing securitised bonds as part of their economic recovery from bankruptcy. For example, Pacific Gas and Electric is seeking to issue $3 billion in securitised energy recovery bonds as part of its bankruptcy settlement not related to stranded costs.

Joseph Fichera, Saber Partners: RRBs are of superior value

Environmental trusts

The security that may gain the most traction is environmental trust financing (ETF).

The instruments are being pioneered by the state of Wisconsin, which passed legislation in October authorising the bonds. The initial application was filed by the Wisconsin Energy Corporation in May 2004 in an effort to lower the cost of financing a number of environmental projects. Wisconsin Energy expects the $490 million bond issuance to save customers $175 million over traditional financing mechanisms.

David Lovell, senior analyst at the Wisconsin Legislative Council and staff to the Senate Committee on Energy and Utilities says the environmental trust financing order granted by the state is broad. Utilities can use the bonds to cover any environmental control costs – intended uses of the bonds cited by Wisconsin

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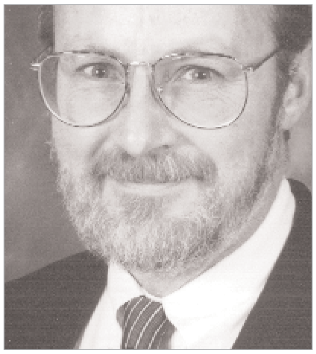

J. Paul Forrester, Mayer, Brown and Rowe: **"We hope to see more environmental trust financing. We are gearing up for it"**

Energy include emissions reduction at existing plants, decommissioning of coal-fired plants and plant clean-up. "We are anticipating big investments in environmental controls. They are necessary to the state's economy," says Lovell. The expectation is that a number of states will eventually authorise similar environmental bonds. Lovell says the securities were recently touted as a "new innovative idea" to the chairs of state energy committees across the country at a recent conference.

"We hope to see more of these types of bonds. We are gearing up for it," says J. Paul Forrester, a partner at law firm Mayer, Brown and Rowe, a major player in asset-backed securitisation. Forrester expects the large expenditures required to clean up coal-fired plants will help create a market over the next year. But he says the real upturn will come when the US Environmental Protection Agency (EPA) passes its new rules for controlling mercury emissions. The EPA is expected to reissue the rule in March of next year. Many utilities are deferring new expenditures on nitrogen oxide (NOx) and sulphur dioxide (SO2) emissions control technology until the new mercury rules come in so that they can deploy the right technology to deal with all three pollutants.

Forrester says the technology and financing around mercury control will be complex and will involve taking plants off line for as long as six months to make the modifications. The retrofits will affect credit and revenues.

Peer pricing

The environmental trust bonds are expected to price in the same range as RRBs, in line with unsecured corporate utility debt. Those involved in the issue say analysts are interviewing banks for the underwriting process and the securities should be on the market in the first quarter of 2005. Joseph Fichera, chief executive of New York financial advisory firm Saber Partners and an adviser to Wisconsin Public Service Commission, says the bonds should be priced lower. In general, Fichera says, RRBs are priced too generously.

Indeed, recent deals point to lower pricing and wider distribution for the rate reduction bonds and their derivatives. One trend-setting deal was TXU's Oncor Electric issuance. The Oncor RRB trades the closest to corporate utility debt of RRBs in the market. Key to earning attractive pricing was novel performance-based underwriting incentives. Saber's Fichera, the consultant to the Texas Commission, says demand has always been strong for RRBs but the challenge remains of getting bankers to distribute them broadly enough to lower costs. Due to the increased complexity of the asset-backed instrument, they are popular with large institutional investors such as insurance companies who can do the due diligence and benefit from a low-risk investment with "government-like" characteristics.

A recent TXU electric delivery transition bond has further expanded distribution. The issue is for $790 million, with 3-, 7- and 10-year tranches priced at an attractive 3, 11 and 14 basis points over triple-AAA swaps, respectively. A favourable capital requirement ruling in Europe, lowering the cost of capital, has increased demand for the issue. The deal received a 20% weighting under international risk-based capital rules rather than the 100% usually accorded RRBs in Europe, thus lowering the capital investment requirement and increasing the return on capital.

State regulators are now becoming more proactive in pushing for more attractive pricing. "In Texas, with strong government involvement, there has been a lot of progress made, with tighter and tighter spreads throughout the process. But there is still a long way to go," says Fichera. He sees the need for more aggressive marketing by investment banks, but sees regulators taking more control of the selection of banks and the marketing process. The Oncor 2- and 5-year tranches are priced at 7 basis points each above AAA-rated swaps in August 2003. Spreads in the RRB market as a whole followed suit and have remained tight. Since

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Joseph Fichera, Saber Partners, on the push for more attractive RRB pricing

January 2004, spreads on 2- to 10-year RRBs have tightened 5 to 8 basis points on average, according to Barclays Capital.

Fichera expects the Wisconsin bonds to be well-priced: about the same as Oncor Electric. First, he says, it is a large, liquid issue, at around $500 million. Second, it is a "non-headline risk" state (read: 'not California') and both its utilities are strongly rated by credit-rating agencies. In addition, Wisconsin plans on implementing a performance-based incentive model for underwriters similar to that of Oncor.

AAA

Some argue RRBs should trade more akin to other government-backed securities, even treasuries. The securities are backed by a surcharge on rate plans, and if required the charge can be adjusted through a mechanism to respond to changes in the customer base. As a charge on electric bills, the first dollar collected goes to bondholders and the second dollar to utility operating expenses. In addition, they have a triple-A backing. Jeff Salmon, director of asset-backed research at Barclays Capital in New York, holds up the PG&E bankruptcy as a recent credit test. Concerns over default on the bonds were alleviated when the credit rating agencies stated there was no risk of default on California's RRBs. The bonds have also experienced little to no negative credit events. Nomura Securities reports no defaults or downgrades on 30 issues. The largest cause of turbulence to the market was California's Proposition 9 in 1998. Consumers lobbied against the state's three major utilities setting up special purpose entities to securitise and recover stranded assets. The referendum was overturned by the California Supreme Court.

Asset securitisation will continue to receive more credit rating agency and regulatory scrutiny following the fall of Enron's house of special purpose vehicles. But the market is showing a healthy appetite for properly structured deals. Barclay's Salmon says demand is growing for RRBs, which is helping to tighten spreads. "Paper in the secondary market continues to trade at very tight levels and we expect that will continue," he says. ER

Many utilities have had to decommission old plants rendered uneconomical through the deregulation process, like this one in California. But how to recover these stranded costs?